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SUBJECT: RESPONSE: IMPACT OF RISING FOOD/COMMODITY PRICES
-- GEORGIA

REF: STATE 39410

¶1. Summary: Food price inflation was 14 percent in 2007 in Georgia. Higher food prices make meeting calorie intake needs more difficult for many Georgians, especially those living in poverty. The government does not subsidize agriculture, other than to provide some equipment that can be rented by farmers and some vouchers for diesel fuel. Plans to lower agricultural tariffs are on hold for now. The USG is providing almost \$3.5 million in assistance to the Georgian agricultural sector in 2008. These programs can help reduce food price inflation by improving productivity of domestic agriculture. End Summary.

¶2. Overall inflation for the year 2007 in Georgia was 11 percent, but food prices increased 14 percent. The price of bread increased 33 percent due to higher worldwide wheat prices, sunflower oil increased 65 percent and maize (corn) flour increased 50 percent. However, prices for eggs, beans, sugar, potato and meat decreased. Many of the prices for these commodities had increased greatly in 2006, due to a poor harvest and worries about avian flu, and the relatively slight decreases in prices were from historically high levels. Prices are continuing to increase in 2008 with higher costs of petroleum and natural gas imports. Georgia has benefited from a trend of appreciation of the national currency against the dollar which has helped reduce the impact of global price increases. Agriculture has been declining as a percentage of GDP for several years, and made up about 10 percent of GDP in 2007.

¶3. Demand: Staples in the Georgia diet are bread, pasta, potatoes, meat, dairy products, fruit and vegetables. As food prices increased 14 percent over 2007, average wages increased 21 percent from third quarter 2006 to third quarter ¶2007. Many Georgians are not involved in paid employment and are unemployed or self-employed in agriculture or other occupations, so wage growth may not necessarily reflect an increased ability to absorb higher food prices, especially among the 33 percent of the population that lives under the poverty line. Urban residents are more affected by price increases because they purchase most of their food. Many rural residents grow much of their food and preserve fruits and vegetables for winter consumption. However, higher food prices reduce their ability to supplement their diet with purchased products such as flour or meat products.

¶4. Georgia is a net importer of agricultural products. Primary agricultural exports are fresh and processed fruits, wine and brandy, spring and mineral water, nuts and hazelnuts. Primary imports are meats, sugar, grain and dairy products. While exports are increasing and domestic production of meat and dairy is improving, Georgia has a

widely negative trade balance for agricultural products (USD 755.2 million in imports in 2007 versus USD 292 million in exports). Agricultural products are 23.5 percent of Georgia's total exports. Domestic demand is limited by Georgia's small population and low level of disposable income.

15. Wheat is Georgia's leading agricultural import, as domestic wheat production does not cover demand. Land appropriate for wheat production is limited and producers in some traditional wheat producing areas are beginning to cultivate high value crops such as fruits and vegetables, which have greater potential returns. Therefore, it is unlikely that local production will meet all consumption needs in the short and medium term. The Georgian market requires an availability of 45,000 metric tons per month to meet domestic needs. Georgia is a net wheat importer, with Kazakhstan and Ukraine as its primary suppliers. Despite the importance of bread in the Georgian diet, prices are not controlled or subsidized.

16. The Ministry of Agriculture is concerned about the impact of higher worldwide prices for wheat and sunflower oil. Median calorie intake fell in 2006 in both urban (by 12 percent) and rural (by 7 percent) areas. This reduction may have been connected with the poor harvest and in urban areas with the influence of higher prices. At the same time, average incomes have been rising which may permit an increase in calorie intake in 2007 and 2008 if price rises are not so steep as before.

17. Supply: Domestic agricultural production is unlikely to respond significantly to rising food prices in the short and medium term, as the country lacks basic inputs and appropriate agronomic conditions to implement sudden shifts

TBILISI 00000741 002 OF 003

in production. Domestic production has been increasing over recent years, as the country recovers from economic hardship resulting from the breakup of the Soviet Union. Domestic and foreign investments are contributing to agricultural growth, but so far do not seem to be related to rising food prices. Arable land accounts for more than 35 percent of Georgia's total area, with only 10 percent planted in crops. Although agriculture will remain important to Georgia's economy, its production capacity is limited, and the country has no obvious comparative or competitive advantage in any crop or product. Export markets will remain mostly niche markets. For example, 70 percent of the country's citrus crop is exported to Ukraine. Hazelnuts are another major export crop. The continuing Russian embargo on imports from Georgia of fruits and vegetables, wine and mineral water has been a constraint on agricultural production since 2006. However, the embargo has forced the Georgian government and producers to seek markets elsewhere and to improve quality to meet the demands of new trading partners, notably Turkey and Ukraine. With continued improvements in quality and marketing, opportunities exist to develop export crops such as wine, bay leaves, mandarins and kiwi.

18. The Ministry of Agriculture has identified storage as a major bottleneck preventing an increase in fruit and vegetables. Other constraints on agricultural development are small size of most farm plots, poor quality control, lack of investment in technology and equipment, transportation problems and high costs, lack of credit, and lack of technical and managerial expertise.

19. Political Impact: Georgia has recently experienced a period of political turbulence, but the themes of protest have emphasized political issues more than rising food prices. However, continuing problems of poverty and unemployment have been an underlying cause of unhappiness with the current government, which are related to inflation concerns that affect the public's ability to buy food.

¶10. Economic Impact: Higher food prices have naturally contributed to Georgia's overall inflation rate, but price increases for housing, water, electricity, natural gas and other types of fuel have had a bigger impact. Georgia's current account deficit is large and is one of the major risk factors for the economy. The wide trade deficit in agricultural goods noted above is a significant contributor to that deficit. Nevertheless, there is potential for increasing agricultural output and exports to the benefit of the economy. Agriculture has attracted some significant investments recently, most notably by the Italian company Ferrero for production of hazelnuts. Besides planting new trees, Ferrero is building processsing facilities.

¶11. Environmental Impact: Rising food prices have not had a notable impact on environmental issues. Water is abundant in Georgia. The government is trying to rehabilitate and extend irrigation systems built during the Soviet period. Chemical and fertilizer use is limited but as agriculture expands, their use could become more extensive with concomitant environmental risks.

¶12. Government Policy Response: High level support for coordinated, effective agricultural policies is needed. Ad hoc policies are aimed more at reviving agriculture generally than at alleviating the impact of high prices. Programs to provide USD 17 million in low-cost credit and to develop 100 new agricultural enterprises is under way. The government negotiates directly with Ukrainian and Kazakh state-owned wheat exporters to try to obtain the best price on wheat for the Georgian market and set rules and conditions for imports.

Agriculture is a sector of the economy to which the government would like to attract foreign investment in larger, more efficient farms created from state-owned land. The government offers no major subsidies to farmers, although it has created machinery rental centers in rural areas by supplying farm equipment at cost to towns in the regions. It also is currently distributing a limited amount of vouchers for diesel fuel to offset higher fuel prices. After reducing most tariffs to zero, only agricultural products still benefit from tariff protection at rates of 12 and 5 percent. The government has shelved plans to reduce all remaining tariffs to zero in order to preserve an incentive for domestic production and foreign investment in the agricultural sector. A free trade agreement was concluded with Turkey in 2007. Turkish tariffs have been reduced to zero on wine, citrus and anchovies from Georgia. Other tariffs on agricultural imports are high but will gradually be reduced for Georgia under the terms of the FTA. Georgia

TBILISI 00000741 003 OF 003

is also pursuing an FTA with the European Union that could help spur agricultural exports. The government has been fairly passive in the face of the Russian boycott of fruits and vegetables from Georgia and has not actively sought to have it reversed. According to the Ministry of Agriculture, Russia imposes a special 102 euro per ton export tax on wheat exported to Georgia.

¶13. Impact on Post Programs: The USG provides significant assistance to Georgian agriculture, totaling USD 3.47 million in FY 2008. USDA is supporting programs for improving agricultural education, agricultural statistics, veterinary health and for Cochran Fellowships to provide Georgian agribusiness owners and government officials with experience in the United States. USAID programs focus on providing rural enterprises with expertise. The Millennium Challenge Corporation's investment program is investing in agricultural enterprises and building infrastructure that benefits rural areas. USG programs are not likely to be significantly impacted by higher food costs, but their ongoing aim is to increase the productivity and export-preparedness of the Georgian agricultural sector, thereby increasing supply and hopefully helping to blunt food price inflation.

TEFFT